

Corporate

SEC Expands Definitions of Accredited Investor and Qualified Institutional Buyer to Promote Private Offerings

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Introduction

On August 26, 2020, the Securities and Exchange Commission, or the Commission, adopted amendments to expand the definitions of “accredited investor” under Rule 501(a) of Regulation D promulgated under the Securities Act of 1933, as amended, or Securities Act, and “qualified institutional buyer” under Rule 144A of the Securities Act.^[1] The amendments are effective 60 days after publication in the Federal Register.

Background of Amendments

The Commission originally proposed amendments to the definition of accredited investor and qualified institutional buyer in December of 2019.^[2] According to the Commission, the proposed amendments were intended to update and improve the definitions in order to more effectively identify institutional and individual investors possessing sufficient knowledge and expertise to participate in private investment opportunities not subject to registration under the Securities Act.^[3] The Commission observed that although an individual’s assets or income is a key aspect with respect to accredited investor status, other education, experience and knowledge in the private offering space could also provide such individuals with accredited investor status.

Amendments to Accredited Investor Definition Benefiting Individuals

In the Proposing Release, the Commission solicited input on which individuals or groups of individuals should qualify as accredited investors outside of the current rules, which principally rely on an individual’s assets or income.^[4] The Commission considered, among other things, professional designations, education or degree status as conferring the type of expertise that could result in accredited investor status.

New Process for Accredited Investor Determination and Initial Determination

After comment, the Commission amended the definition of accredited investor to allow for additional individuals to be designated through new Rule 501(a)(10). Specifically, the Commission can designate any natural person holding one or more professional certifications or designations or credentials from an accredited educational institution as an accredited investor, provided such person is in good standing with respect to such certification or designation. To determine who qualifies beyond the initial classes of individuals noted below, the Commission listed for consideration the following factors under Rule 501(a)(10):

- **Examination Factor:** The certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution.

- **Securities Relevance**: The examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing.
- **Knowledge Consideration**: Persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment.
- **Verification Condition**: An indication that an individual holds the certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable.

In connection with the adoption of this process, the Commission considered a number of different credentials, including CPAs and those with law degrees, as satisfying the above standards. However, after consideration, the Commission designated individuals possessing the General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82), and the Licensed Investment Adviser Representative (Series 65) as the initial certifications satisfying the accredited investor definition under Rule 501(a)(10). Going forward, the Commission must follow notice and comment rulemaking to add additional groups of individuals under Rule 501(a)(10).

"Knowledgeable Employees"

In addition to the education-based credential process noted above, the Commission added "Knowledgeable Employees" of private funds as accredited investors in such funds under new Rule 501(a)(11). The Commission leaned on existing rules in crafting this addition. Under Rule 501(a)(11), "Knowledgeable Employee" has the same definition as in Rule 3c-5(a)(4) of the Investment Company Act^[5] and generally includes an executive officer, director, trustee or advisory board member of the fund or any person who participates in the investment activities of such private fund for at least 12 months (other than persons performing solely clerical, secretarial or administrative functions with regard to such company or its investments). The Commission reasoned that through their knowledge and active participation of the investment activities of the private fund, such individuals are likely to be financially sophisticated and capable of fending for themselves in evaluating investments.^[6]

Similar to current rules under the Investment Company Act, the Commission applied the spousal joint interest position in Section 2(a)(51)(A)(i) of the Investment Company Act to a "Knowledgeable Employee" and his or her spouse in the context of accredited investor status under Rule 501(a)(11). The Commission believed that it was appropriate to attribute a Knowledgeable Employee's accredited investor status to his or her spouse with respect to joint investments made by the Knowledgeable Employee and his or her spouse in a private fund. Note that this definition does not extend to all investments, but those that are joint investments.

Amendments to Accredited Investors Definition Benefiting Entities

In addition to expanding the definition of accredited investors for individuals, the Commission further expanded the definition for several category of entities.

1. **Certain Investment Advisors**: The Commission added investment advisors registered under Section 203 of the Investment Advisers Act, and investment advisors registered under the various state laws and exempt reporting advisers under Section 203(m) or Section 203(l) of the Investment Advisers Act as accredited investors under revised Rule 501(a)(1).
2. **Rural Business Investment Companies**: Similar to small business investment companies that currently qualify as accredited investors, rural business investment companies were added under revised Rule 501(a)(1) as well.

3. **Limited Liability Companies meeting the Requirements of Rule 501(a)(3)**: The Commission added limited liability companies to the list of entities under Rule 501(a)(3). Under Rule 501(a)(3), such limited liability companies must have more than \$5,000,000 in assets and not be formed for the specific purpose of acquiring the securities offered.^[7]
4. **Catch-All Certain Entities Owning Investments**: The Commission adopted new Rule 501(a)(9), adding any entity, including Native American tribes and labor unions, owning “investments” as defined in Rule 2a51-1(b) of the Investment Company Act, in excess of \$5 million that is not formed for the specific purpose of acquiring the securities being offered as an accredited investor.
5. **Family Offices**: A “family office”, as defined by Rule 202(a)(11)(G)-1 of the Investment Advisers Act was also added under new Rule 501(a)(12). Such family office must have at least \$5 million in assets under management, cannot be formed for the specific purpose of acquiring the securities offered and is run by an individual who has knowledge and experience in financial and business matters so as to be capable of evaluating the merits and risks of the prospective investment in order to qualify as an accredited investor under new Rule 501(a)(12).
6. **Family Clients**: Lastly, any “family client”, as defined in Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 of a family office and whose prospective investment in the issuer is directed by such family office qualifies as an accredited investor under new Rule 501(a)(13).

Additional Changes

- **Note to Rule 501(a)(8)**: The Commission added a note to Rule 501(a)(8) to clarify how ownership should be “looked through” for purposes of determining who is an accredited investor. Under Rule 501(a)(8), any entity in which all of the equity owners are accredited investors also qualifies as an accredited investor. The purpose of the note is to clarify that it is appropriate to “look through” various forms of ownership under Rule 501(a)(8) to natural persons in those cases where an equity owner of an entity is itself an entity, but that owner-entity does not qualify on its own merits as an accredited investor.
- **Rule 215**: As a clarifying measure, the Commission amended Rule 215 under the Securities Act to cross-reference the definition of accredited investor to Rule 501, meaning that the two rules are congruent.
- **Expanding Testing the Waters Communications to New Accredited Investors**: The Commission amended Rule 163B of the Securities Act (related testing the waters communications for certain offerings) to include references to Rules 501(a)(9) (the catch-all category discussed above) and (a)(12) (family office category discussed above).

Amendments to Definition of Qualified Institutional Buyer

In addition to the revisions regarding the definition of accredited investor, the Commission considered amendments to the definition of “qualified institutional buyer,” or QIB, under Rule 144A of the Securities Act. To conform with the accredited investor amendments, the following entities were added as QIBs, provided that the entity meets the \$100 million assets test under Rule 144A:

1. **Rural Business Investment Companies**: Similar to the accredited investor addition, the Commission elected to add rural business investment companies as a QIB due to their similarity to small business investment companies.
2. **Limited Liability Companies**: In addition to the list of entities discussed in Rule 144(a)(1)(i)(H), limited liability companies were specifically added as an approved form of entity.

3. **Catch-All Category:** The Commission added a catch-all category for institutional accredited investors (as defined in Rule 501(a)) that were not formed for the purpose of acquiring the securities being offered. The Commission specifically noted Native American tribes, governmental bodies, and bank maintained collective investment trusts as entities that would meet this catch-all QIB category.

Compliance Date

The rules are effective 60 days after the date of publication in the Federal Register.

[1] Securities and Exchange Commission, Amending the “Accredited Investor” Definition (August 26, 2020) *available at* <https://www.sec.gov/rules/final/2020/33-10824.pdf> (“Adopting Release”).

[2] Securities and Exchange Commission, Amending the “Accredited Investor” Definition (Dec. 18, 2019) *available at* <https://www.sec.gov/rules/proposed/2019/33-10734.pdf> (“Proposing Release”).

[3] See Adopting Release at 4.

[4] Rule 501(a)(5) (net worth test) and Rule 501(a)(6) (income test) of the Securities Act.

[5] Rule 3c-5(a)(4) under the Investment Company Act defines a “Knowledgeable Employee” with respect to a private fund as: (i) an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the private fund or an affiliated management person (as defined in Rule 3c-5(a)(1)) of the private fund; and (ii) an employee of the private fund or an affiliated management person of the private fund (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such private fund, other private funds, or investment companies the investment activities of which are managed by such affiliated management person of the private fund, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the affiliated management person of the private fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

[6] The Commission also reasoned that allowing these employees to invest in the funds for which they work (and other funds managed by their employer) as accredited investors also may help to align their interests with those of other investors in the fund.

[7] Note that this amendment is a codification of a long-standing staff interpretation.



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